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Financial Markets

Irving Trust

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Friday
(Noon)

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The past two weeks have provided one of the most perplexing periods for the Fed funds rate so far this year. This episode has left Fed watchers confused and, in general, less certain of the direction of Fed policy. Two technical factors--one fairly obvious, the other less so--have distorted the Fed funds rate at a time when that rate has consistently traded well below its recent lower support levels. The question most asked is: Has Fed policy changed or is this technical? I think it's almost totally technical; here's why.

To understand the behavior of the Fed funds rate, realize that it is the result of the supply of bank reserves relative to needs and of market perceptions of what policy is. That psychology had been sour in early August when the funds rate traded for several days at levels as high as 9 7/8%. More recently, over the past several weeks, the funds rate has traded down as low as 9 1/8%. Now, because the bond market has improved and because money growth seems slower, some feel the Fed has eased. However, the recent weakening in the funds rate is the result of both psychological and technical elements, but represents little if any policy change.

The first and most subtle of the technical factors that lowered the funds rate recently was the Fed's agreement to purchase Treasury securities from foreign customers. That transaction injected $1 billion of reserves into the banking system on the week ended Aug. 17. Foreign central banks probably sold U.S. Treasuries to the Fed to cover dollar sales made in mid-August against their own weakening currencies. Because of the Fed's own need to inject reserves that week, the Fed took the foreigners' securities into its own portfolio, adding reserves. But the timing of this purchase was probably not totally to the Fed's liking. It resulted in an earlier reserve injection than the Fed has typically been making in a statement week. Thus the Fed funds market was somewhat more liquid, and funds therefore traded lower earlier in the week. Indeed, on Wednesday, the Fed was apparently still trying to drain some of this liquidity out to hit its net borrowed reserve target. The Fed has typically been supplying liquidity on Wednesday, after being stingy earlier in the week. This reversal of the typical pattern made the market feel more liquid than it really was.

As for the obvious technical factor, it's the hurricane, Alicia. It probably began disrupting payments patterns in Texas as early as Aug. 16. Such disruption increases the settlement lags in check processing between banks and gives rise to increased Federal Reserve float. This float increases the quantity of reserves available to banks and therefore helps push the Fed funds rate down. The Fed knew about this problem but did not move to counteract it. Some argue that this is evidence that the Fed has eased. However, the Fed may not have had enough information on float and may have decided to wait and basically write off last week as a miss. Certainly the matched-sales done on Thursday, Aug. 25, help to reinforce this view. The Fed is taking no chances with excess liquidity early in this statement week. It has thus operated both on market psychology and on reserve availability. It does not appear to have loosened its policy yet.

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Market Yields

	8/26/83(Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.00%	11.00%	13.50
Effective since	8/8/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	10.00
Federal Funds	9.38	9.50	9.88
Repurchase Agreements	9.25	9.25	8.50
U.S. Treasury Issues			
Bills			
3 months	9.45	9.65	7.80
6 months	9.90	10.02	9.78
1 year	10.35	10.33	10.76
Coupons			
2 years	10.93	10.84	11.76
4 years	11.34	11.30	12.59
7 years	11.58	11.58	12.70
10 years	11.70	11.69	12.61
Long Bond	11.66	11.69	12.37
Negotiable Certificates of Deposit-Secondary Market			
1 month	9.25	9.55	9.40
3 months	9.55	9.70	10.10
6 months	9.90	10.00	11.45
1 year	10.30	10.55	11.75
Banker's Acceptances			
1 month	9.35	9.60	9.40
3 months	9.67	9.77	10.05
6 months	10.00	10.10	11.45
Eurodollar Deposits			
1 month	9.75	9.88	10.25
2 months	10.00	10.00	10.75
3 months	10.25	10.19	11.25
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.27	9.27	8.12
1 month	9.45	9.59	8.68
3 months	9.74	9.87	9.34
Bank Holding Companies			
1 month	9.19	9.33	8.30
Dealer Placed:			
3 months	9.55	9.84	10.00
New AA Corporate Utility Bond	12.95	12.88	14.40
Tax Exempt			
6 month Project Notes	5.35	5.65	5.15
1 year AAA Bond	5.75	5.50	6.75
5 year AAA Bond	7.00	7.20	7.75
20 year AAA Bond	9.10	9.30	9.90

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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